June 8, 2009

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Economist

SUBJECT: LFC Report of Investment Performance – FY2009 Third Quarter

Investment Performance Highlights:

- All state investment agencies improved on their second quarter performance relative to benchmarks. The State Investment Council (SIC) managed Land Grant Permanent Fund (LGPF and Severance Tax Permanent Fund (STPF) were the most impressive performers, beating their overall policy benchmarks by an outstanding 620 and 650 basis points (bps)[1] respectively. The funds' performance was good enough to rank them both in the top 8 percent of U.S. endowment funds.

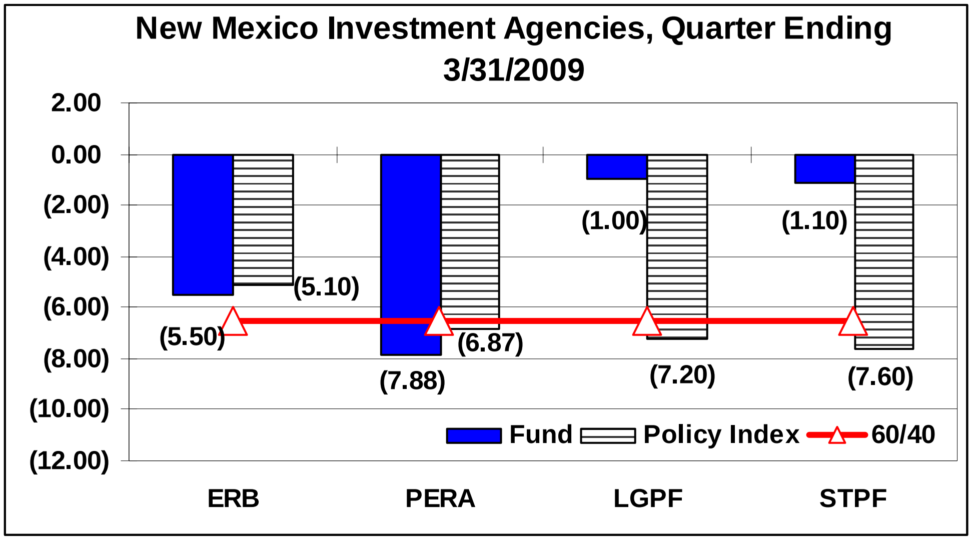
- Both pension funds, the Public Employees Retirement Association (PERA) and the Educational Retirement Board (ERB), underperformed quarterly policy benchmarks. This marks the sixth consecutive quarter that PERA has underperformed its quarterly policy benchmark and the fund continues to be ranked in the bottom three percent of all U.S. public funds for one-year and five-year returns.

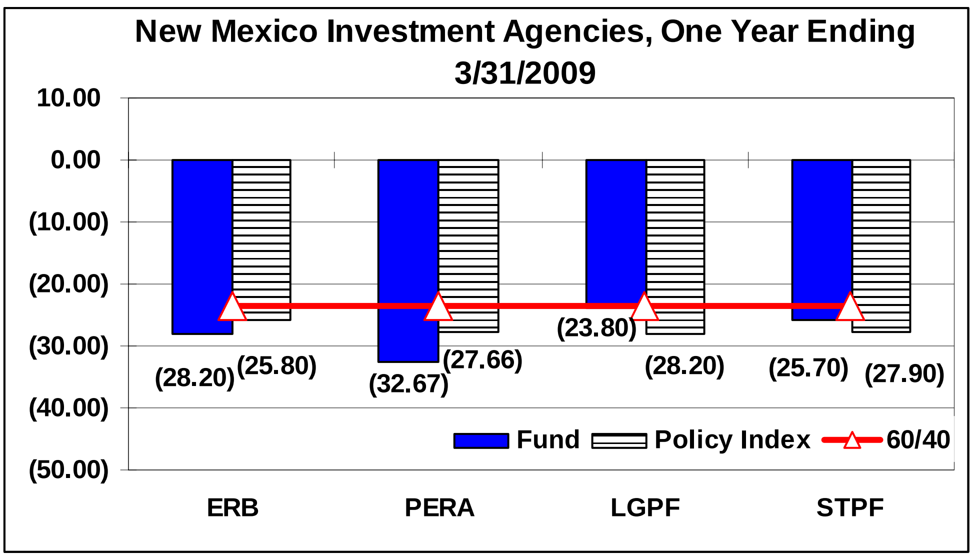
- ERB improved significantly from the previous quarter, missing its quarterly benchmark by only 40 bps. This performance improved the fund's quarterly peer ranking from the 97th percentile to the 45th percentile relative to other U.S. public funds. However, the fund's one-year and five-year returns remain substantially below their respective benchmarks.

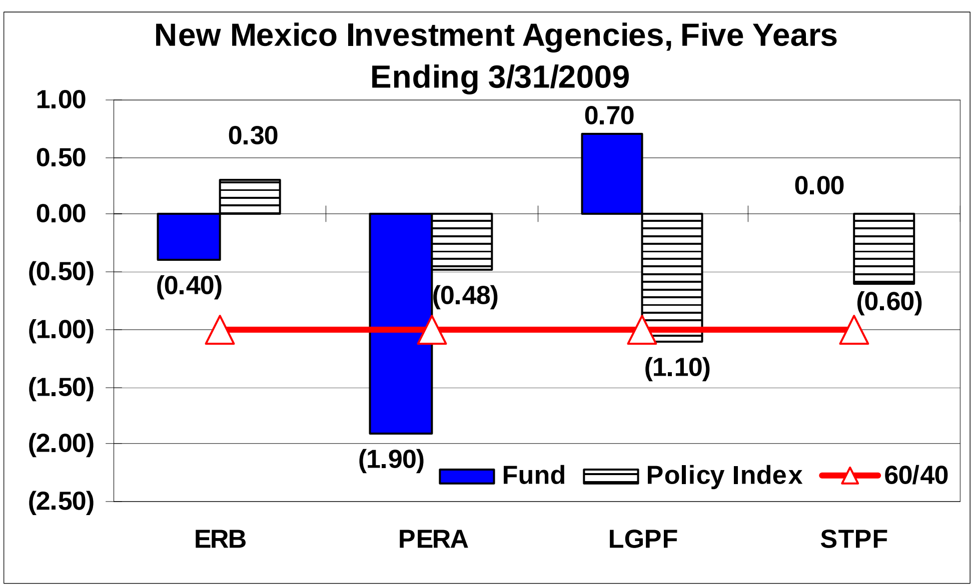
- The primary reason for the SIC managed permanent funds' outperformance of benchmarks was its domestic equity hedging program. The strategy utilizes derivatives products to mitigate risk associated with volatile market conditions and allowed the two funds to outperform the S&P 500 by an impressive 1,140 bps. The program is the subject of this quarter's special focus section.

[1] A basis point represents one hundredth (0.01) of one percent. Thus if the LGPF outperformed its benchmark by 620 bps, it outperformed by 6.20 percent.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







FUND ASSET VALUES

Fund asset value declines slowed marginally in the third quarter of FY09 particularly in the permanent funds. Total asset values for all funds declined $1.3 billion compared to the second quarter and have now fallen $10.3 billion in the last twelve months. This is a dramatic improvement from the funds' second quarter losses of $5.7 billion. The SIC-managed permanent funds lost 1.6 percent and 2.6 percent respectively, constituting a significant improvement from the prior quarter. PERA continues to set the pace for losses, shedding $741 million or 8.3 percent of its overall fund value during the third quarter. ERB also lost significant value as its overall assets declined $395 million, or 6 percent. PERA's overall fund value has now fallen nearly one billion dollars below its December 31, 2003 level of $9.14 billion and is now dangerously close to its actuarial liability level for existing retirees of approximately $7.7 billion. ERB has also fallen below its December 31, 2003 level by more than a half a billion dollars. The pension funds' poor performance continues to raise serious questions regarding long-term solvency, specifically whether or not future contribution increases will be necessary.

Current Asset Values (millions)
For Quarter and Year Ending March 31, 2009

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (3/31/09)	$ 6,207	$ 8,187	$ 7,724	$ 3,074	$ 25,193
Value Change (Previous Quarter)	(395)	(741)	(129)	(83)	(1,347)
Percent Change	-6.0%	-8.3%	-1.6%	-2.6%	-5.1%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (3/31/09)	$ 6,207	$ 8,187	$ 7,724	$ 3,074	$ 25,193
Value Change (Year Ago)	(2,624.9)	(4,115.0)	(2,384.3)	(1,240.7)	(10,364.8)
Percent Change	-29.7%	-33.4%	-23.6%	-28.8%	-29.1%

*Excludes assets held at STO

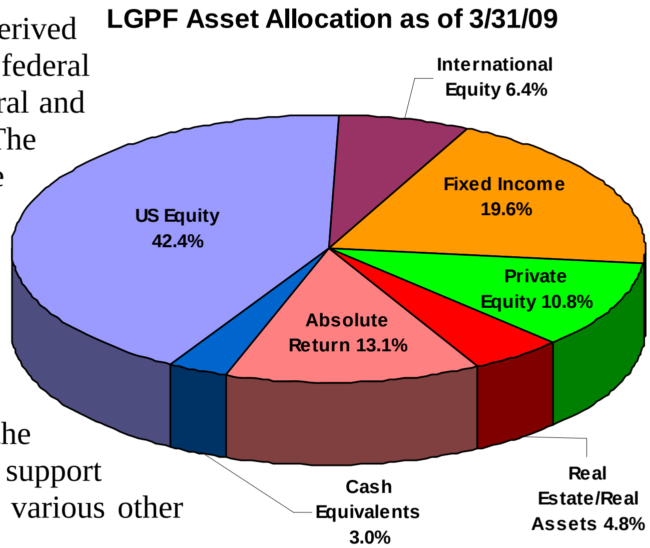
ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The recession that began in late 2007 persisted through the end of the third quarter of FY09. In March unemployment increased to 8.5 percent, its highest point in over 25 years. Other economic indicators such as GDP growth, consumer spending, and consumer confidence showed dismal signs as well. Interest rates remained low as the Federal Reserve kept its target fed funds rate at 0.0 percent to 0.25 percent while simultaneously propping up the U.S. Treasury market with large purchases. Despite the low interest rate environment the consumer price index (CPI), a leading indicator of inflation, increased only 0.5 percent during the quarter.

Financial markets followed the bleak economic outlook for a majority of the third quarter until a dramatic market rally took place in March representing the sixth best monthly return the S&P 500 Index has seen in 20 years. Nearly every major worldwide financial index took part in the impressive rally helping to buoy indexed returns for the quarter. Despite the strong rally in March, the S&P 500 finished the quarter down 11.01 percent and is still down more than 38 percent for the 12-month period ending March 31st. Although international equities benefited from some of the largest increases in March, most international indices remained significantly negative for the quarter and are down by more than 45 percent for the year. All major fixed income indices finished the quarter in positive territory as treasury rates have improved marginally, but still remain near all-time lows.

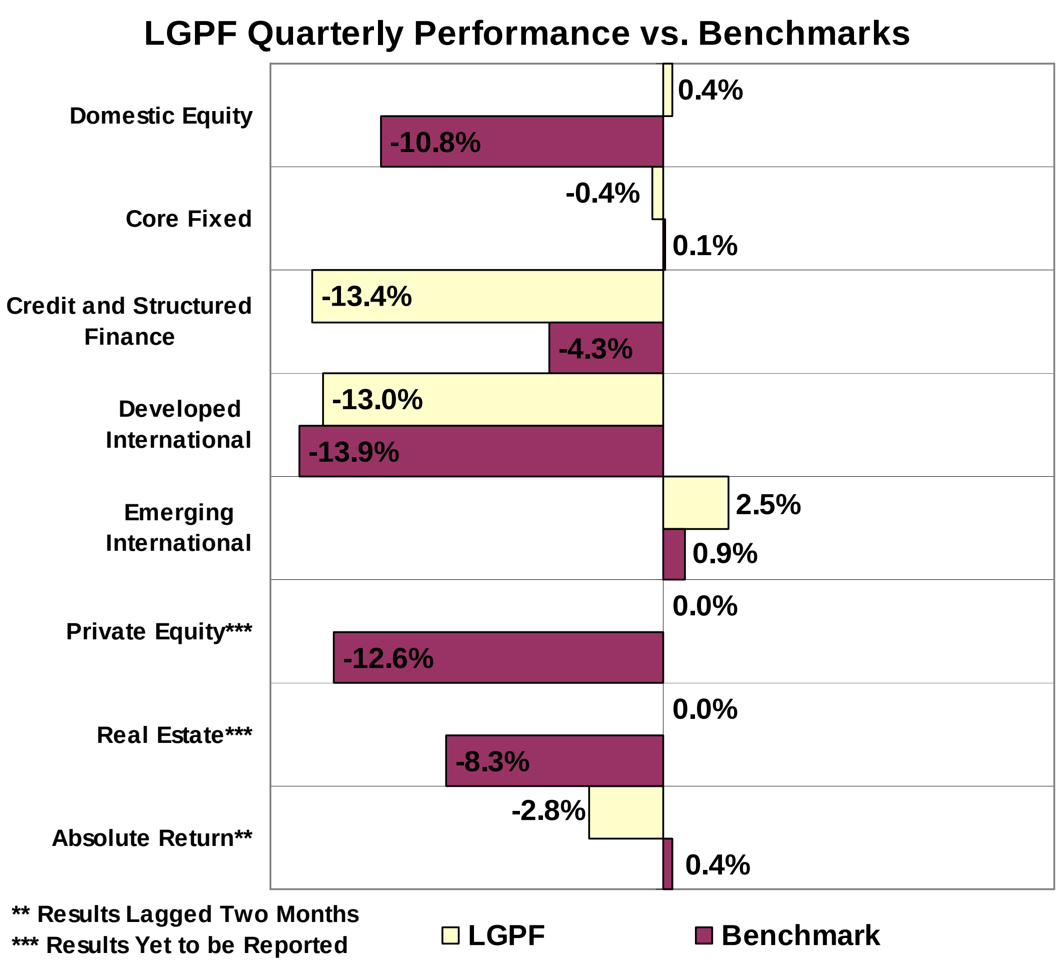
Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-1.00%	-7.20%	7	-23.80%	-28.20%	35	0.70%	-1.10%	34

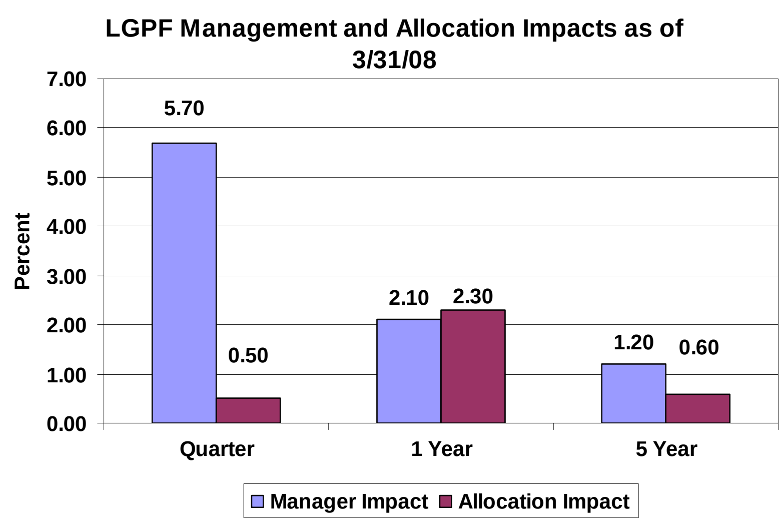


Contributing Factors: The LGPF convincingly beat its quarterly policy benchmark by 620 bps during the third quarter of FY09. The outperformance pulled the fund's quarterly peer ranking from the 91st percentile into the 7th percentile relative to other U.S. endowment funds. More importantly, the magnitude of the fund's outperformance was enough to improve its one-year and five-year rankings into the 35th and 34th percentiles respectively. These numbers may be slightly overstated due to the fact that it does not include private equity or real estate returns as they were not yet submitted at the time this report was compiled.

The fund's impressive outperformance of its policy benchmark can be attributed largely to the SIC's domestic equity hedging program. The program allows SIC to mitigate downside risk from its domestic equity exposure by sacrificing a portion of its upside potential. This strategy, discussed in more detail in this quarter's special focus section, coupled with solid manager performance caused the fund to outperform the Russell 3000 Index by 1,120 bps and the S&P 500 by 1,140 bps. This method of hedging risk has allowed SIC to maintain the fund's domestic equity exposure relatively high in comparison with other funds. In contrast, SIC has limited its exposure to international equity, a much more volatile asset class whose returns have been dismal across the board for the past 18 months. This has thus far proven to be a more effective strategy given the challenging market conditions of the past year and a half.

Despite the fund's outstanding performance throughout the majority of its portfolio, its fixed income assets continue to underperform. Although the underperformance has not significantly affected overall returns as of yet due to the fund's relatively small allocation, consistent fixed income underperformance is disturbing given the asset class's traditionally safe and conservative nature. The fund's allocation and dramatic underperformance in the credit and structured finance arena are particularly unsettling.

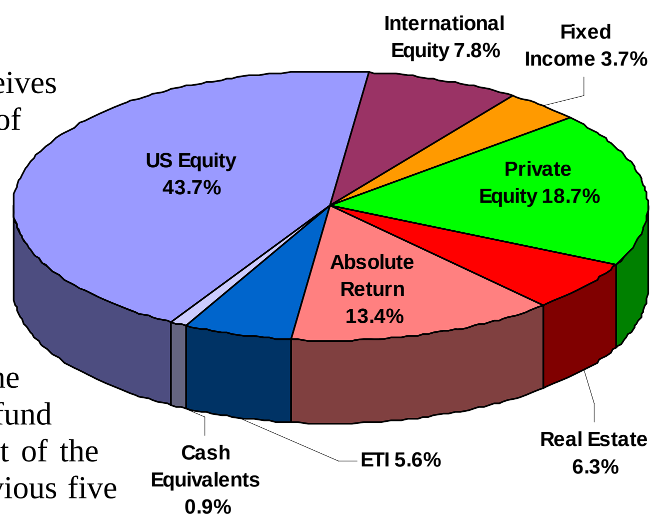
Management and Allocation Impacts: In the third quarter of FY09, active management boosted the fund's overall return 570 bps while asset allocation added 50 bps. This marks a turnaround from the previous two quarters in which active management proved detrimental to the overall fund's return, while portfolio allocation continues to benefit performance. The magnitude of this quarter's positive performance also caused the one-year and five-year manager impact to turn significantly positive. The primary reason for such a dramatic turnaround was the fund's domestic equity hedging program.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

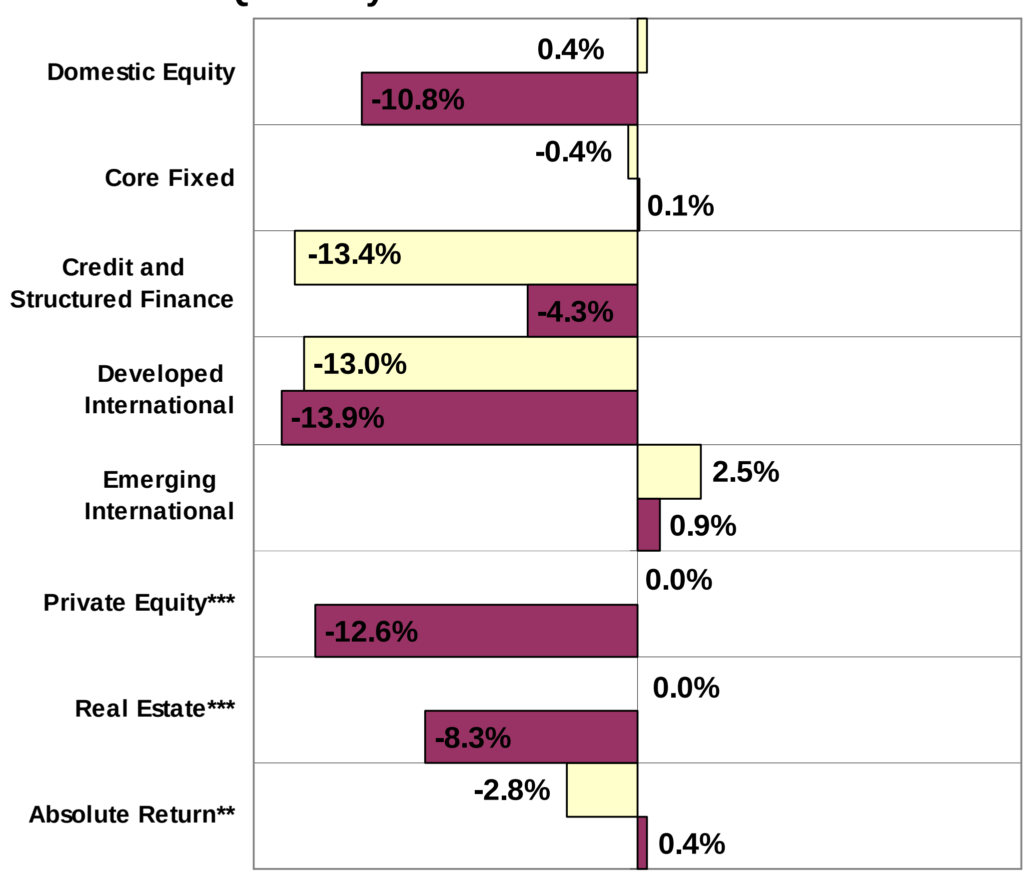
STPF Asset Allocation as of 3/31/09



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-1.10%	-7.60%	8	-25.70%	-27.90%	52	0.00%	-0.60%	46

STPF Quarterly Performance vs. Benchmarks

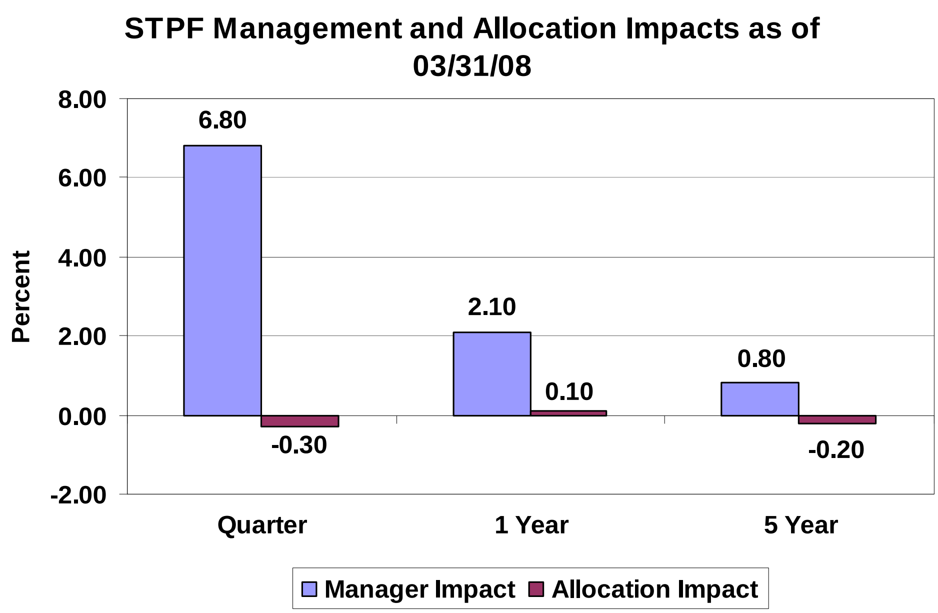


** Results Lagged Two Months
*** Results Yet to be Reported

Contributing Factors: The STPF outperformed its quarterly benchmark by 650 bps during the third quarter of FY09. This number may be slightly overstated due to the fact that it does not include private equity or real estate returns as they were not yet submitted at the time this report was compiled. However, due to the poor performance of relative benchmarks and the performance of both private equity and real estate markets as a whole these numbers will undoubtedly be negative. These negative returns will have a much greater impact on the STPF than the LGPF given the fund's large alternative allocation of over 44.0 percent. Due to the fund's domestic equity hedging program and strong manger performance, its returns remained impressive relative to benchmarks and other endowment funds throughout the U.S. The fund's national quarterly ranking amongst endowment funds improved from the 94th percentile in the second quarter of FY09 to the 8th percentile this quarter.

Like the LGPF, the STPF holds a number of alternative investments including economically targeted investments (ETI) in its portfolio as a diversified alternative to normal fixed-income securities. In fact, due largely in part to various statutory requirements, the STPF has in excess of 15 percent more alternative investment exposure than the LGPF. This factor alone has led the STPF to consistently underperform the LGPF over time. These investments have continued to underperform alternative and fixed income benchmarks. SIC staff have stated that they intend to decrease the fund's exposure to both private equity and absolute return strategies going forward, however as we have stated in previous reports a review of these assets as acceptable alternatives to standard fixed-income securities as well as the amount of economic stimulus attributable to ETI may be in order.

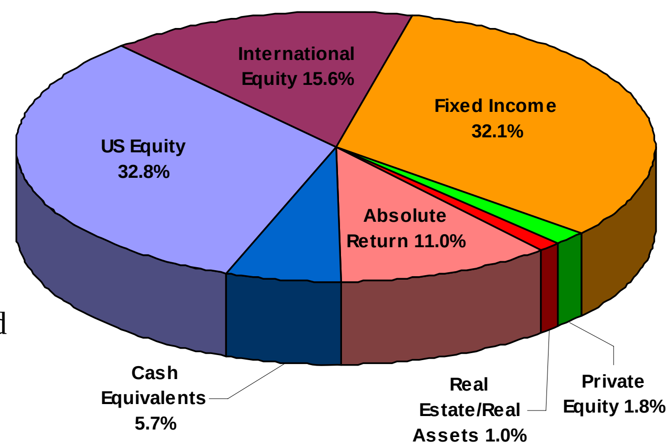
Management and Allocation Impacts: In the second quarter of FY09, active management added 680 bps to STPF returns while asset allocation cost the fund 60 bps. The allocation impact was 80 bps lower than the LGPF due primarily to the funds large alternative asset allocation. The management impacts are due primarily to the fund's domestic equity hedging program.



Public Employees Retirement Association (PERA)

Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate.

PERA Asset Allocation as of 03/31/09

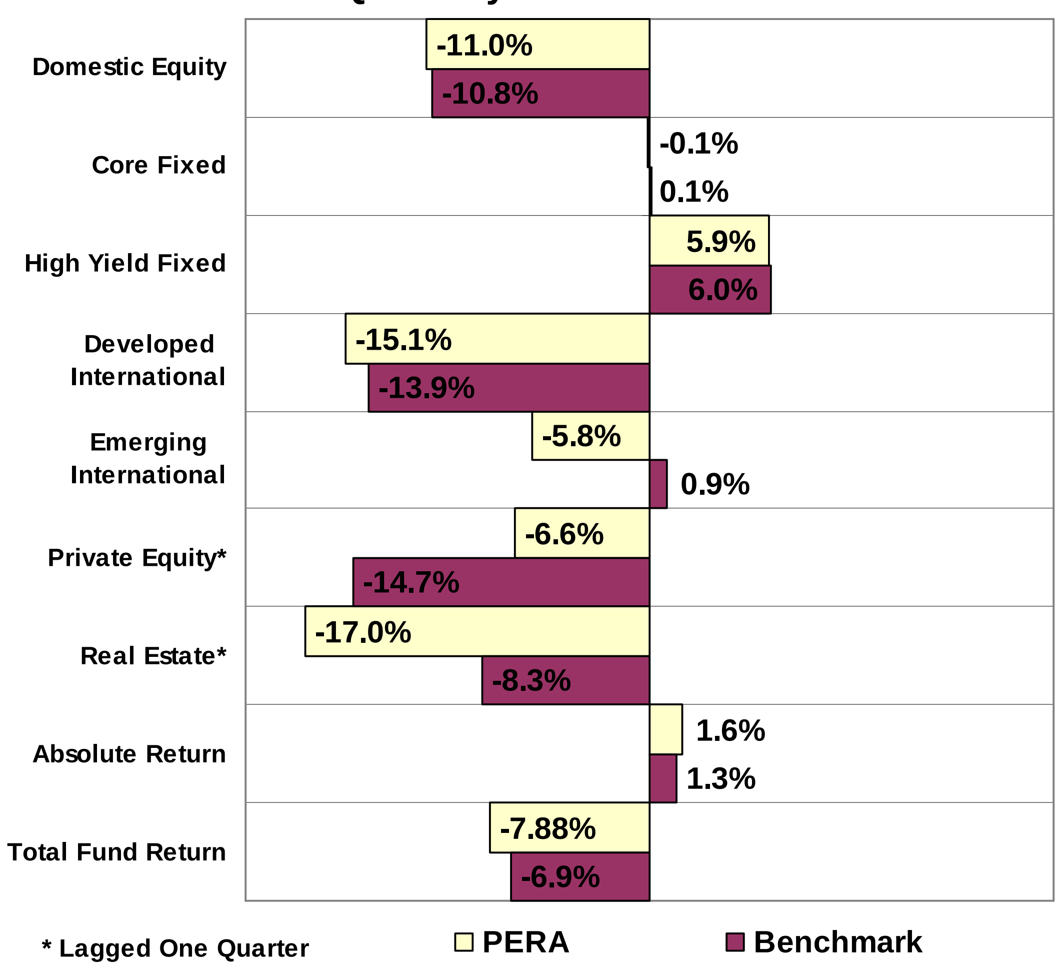


Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-32.67%	-27.66%	97	-1.90%	-0.48%	97	2.08%	1.52%	77

*PERA also has a long-term 8% actuarial benchmark for funding purposes.

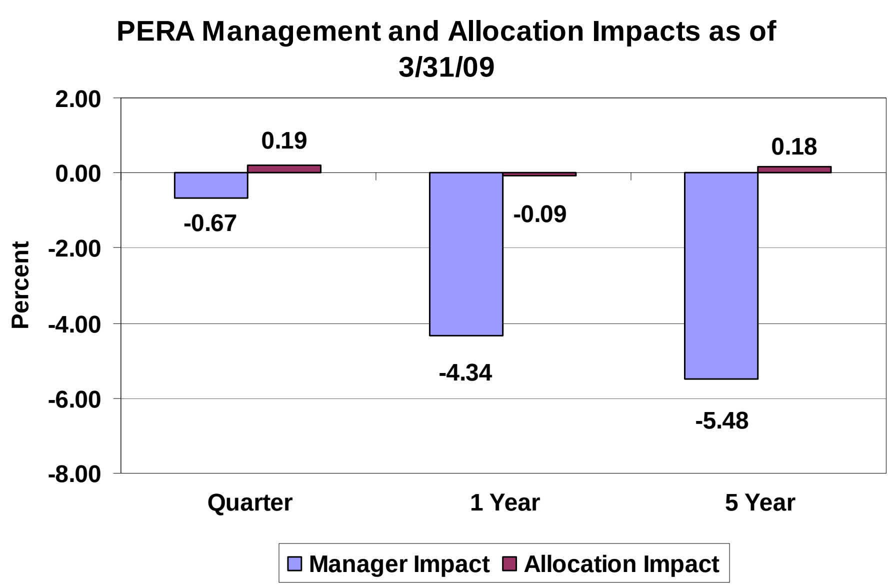
PERA Quarterly Performance vs. Benchmarks



Overview: PERA missed its overall policy benchmark for the sixth consecutive quarter, this time by 98 bps, placing the fund in the 83rd percentile of U.S. public funds for this period. Although the fund's quarterly peer ranking improved, its one-year and five-year rankings remain in the bottom three percent of all U.S. public funds. The decline in the fund's 10-year return to 2.08 percent is also a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. The fund's poor performance continues to raise serious questions as to whether future contribution increases will be necessary to ensure long-term solvency.

The fund underperformed relative to benchmarks in every asset class with the exceptions of private equity and absolute return. This relative underperformance is almost entirely attributable to external manager underperformance. PERA has had difficulty finding successful managers to handle its portfolio and has subsequently been forced to terminate 10 investment managers over the past two years. Unfortunately it appears that further steps may need to be taken to stem the tide of underperformance. If this type of performance continues, additional consideration needs to be given to the tradeoff between active and passive management. Over the past 12 months the fund has spent more than $18.7 million on manager fees. The board also took steps to lessen the fund's exposure to volatile equity markets in the third quarter, including the temporary suspension of its portable alpha program. Although this may have been a long overdue adjustment, the move ended up penalizing the fund's quarterly returns by as much as 54 bps as equity markets rallied shortly thereafter. This underperformance was compounded by the fact that the move was temporary and thus the fund's policy benchmark still factored in a 60 percent equity allocation. PERA is currently reviewing its long-term target asset allocation policy in order to reduce volatility and improve performance. This revised allocation will most likely include more alternative investments given the fund's relatively low current target allocation of 8 percent.

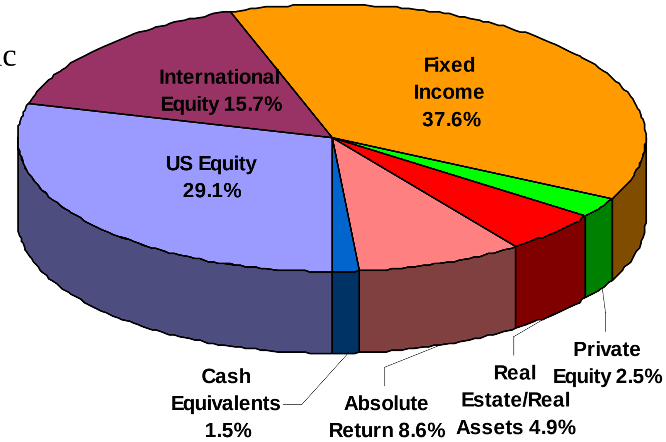
Management and Allocation Impacts: Active management cost PERA 67 bps in the third quarter of FY09. This is not a new trend, as active management has consistently hurt PERA returns due to underperforming external investment managers. Over the past five years active management has cost the fund 548 bps, while its portfolio allocation has only added back 18 bps.



Educational Retirement Board (ERB)

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits. As of June 30, 2008, ERB had 31,192 retirees and 63,698 active members.

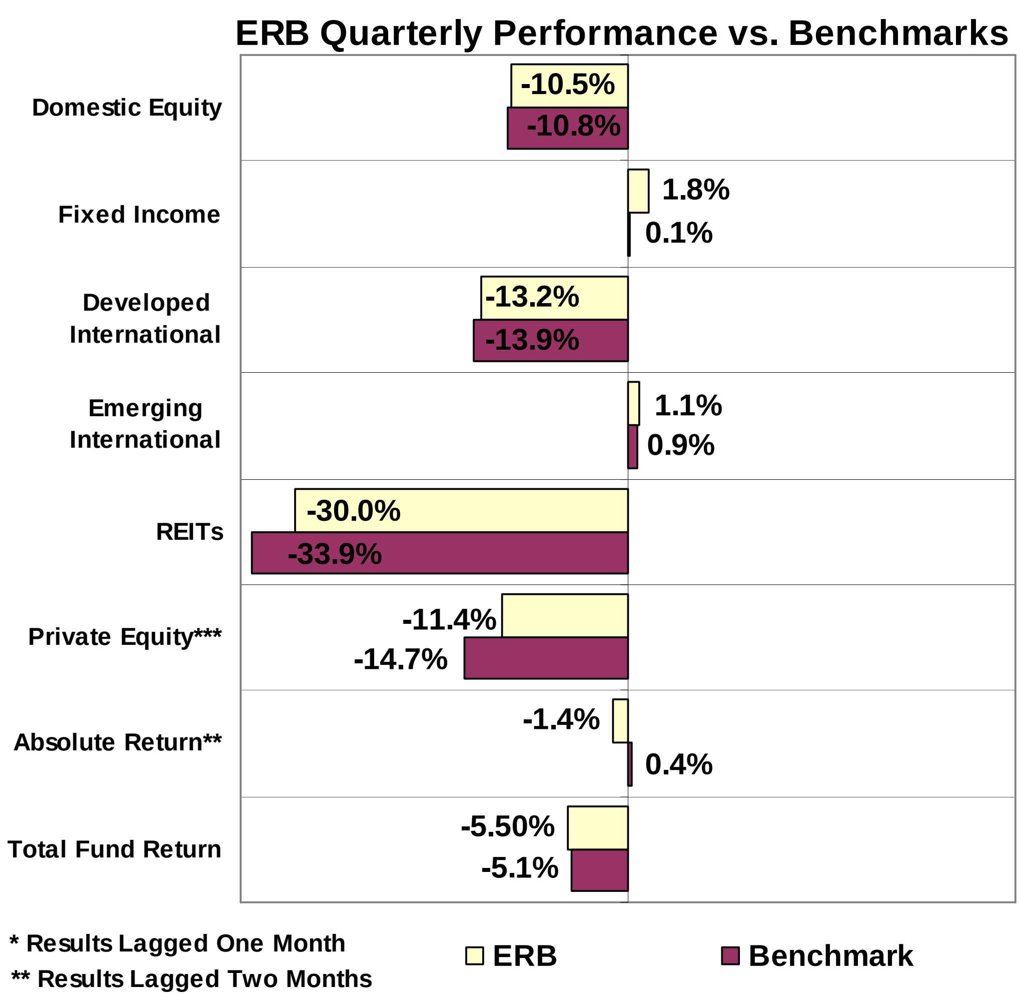
ERB Asset Allocation as of 3/31/09



Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-28.20%	-25.80%	70	-0.40%	0.30%	62	1.10%	1.70%	92

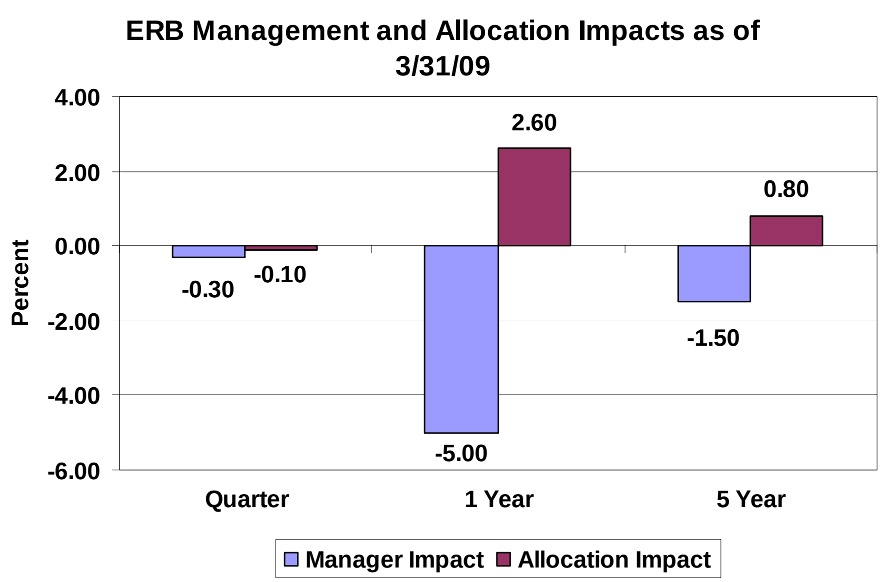
*ERB also has an 8% actuarial benchmark for funding purposes.



Overview: ERB narrowly missed its quarterly policy benchmark by 40 bps and has underperformed both its one-year and five-year benchmarks by significant margins. The fund's ranking versus other U.S. public funds improved slightly in the third quarter however the fund's ten-year returns remain in the 92nd percentile relative to other U.S. public funds. Like PERA, the fund's decline in its 10-year return to 1.1 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. The fund's mediocre performance continues to heighten concerns regarding long-term solvency.

Despite underperforming its quarterly policy benchmark, the fund was able to outperform benchmarks throughout the majority of its portfolio. The fund's performances in a number of asset classes were dramatically improved from the previous quarter. Fixed income for example, which was primary factor in the fund's underperformance last quarter, outperformed the Barclays Aggregate Index by 170 bps and ranked in the 17th percentile of U.S. public fund fixed income returns. Domestic and international equity performances relative to benchmarks were also much improved from a quarter earlier. The fund's worst performing asset class relative to benchmarks was its absolute return portfolio which missed by 180 bps. This asset class was also a major underperformer during the second quarter as well. Without this underperformance, the fund would have performed more in line with and possibly better than its overall policy benchmark. ERB staff and its advisors are currently reevaluating their absolute return strategies in order to improve overall fund performance. The fund also plans on significantly reducing its exposure to Real Estate Investment Trust (REIT) investments over the next 12 months, and instead increase its holding in direct real estate investments.

Management and Allocation Impacts: Both the fund's asset allocation and active management cost the fund during the third quarter. Its one year allocation impacts are impressive as the fund has been able to increase returns by under allocating both domestic and international equity investments relative to policy targets. This limited the fund's exposure to two of the worst performing asset classes over the past year. However, manager performance, normally a plus for the fund, has fallen off sharply over the past 12 months.

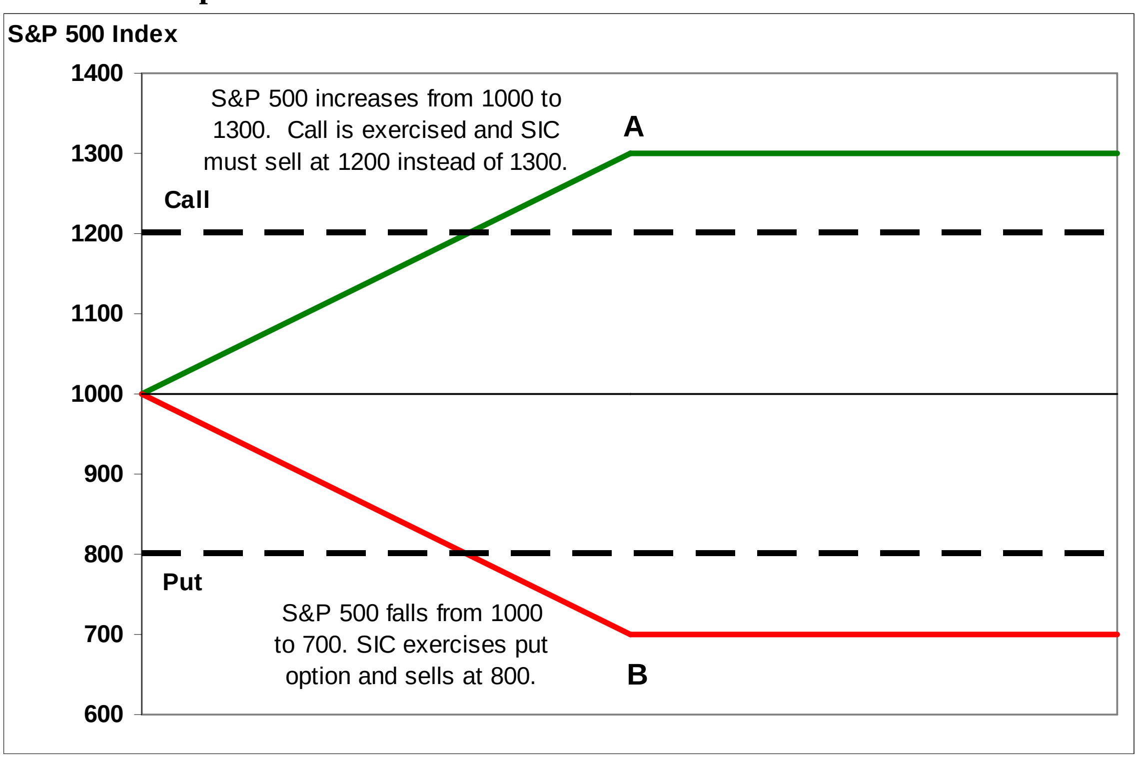


SPECIAL FOCUS: Hedging of Domestic Equity Exposure by SIC

During the 3rd quarter of FY09 SIC was able to achieve outstanding returns in the area of domestic equity, whereas the previous quarter its domestic equity returns were significantly lower than benchmarks. The primary reason for such over and under performance was the agency's domestic equity hedging program. The strategy, implemented through the use of derivative products, is designed to protect against domestic equity downside risk at the cost of some upside return potential. This strategy is more commonly known as a costless collar.

Derivative products are traded on specialty markets in which contracts are made with other market participants. Therefore in order for SIC to enter into a derivatives contract, another investor or "counterparty" must be willing to enter into an opposite contract. For example if the SIC were to purchase a "put[2]" contract, which means that SIC would have the right to sell an underlying asset at a predetermined price, a counterparty must buy the underlying asset at the same predetermined price. Derivatives are in this sense a "zero-sum game." A simplified example is presented in Chart 1 below in which a collar is placed on the S&P 500 index. In this example SIC has sold a call option at 1,200 and purchased a put option at 800. The chart outlines two different scenarios based on which direction the index is moving from a starting point of 1,000. For simplicity purposes the effects of options prices will be excluded in these two scenarios.

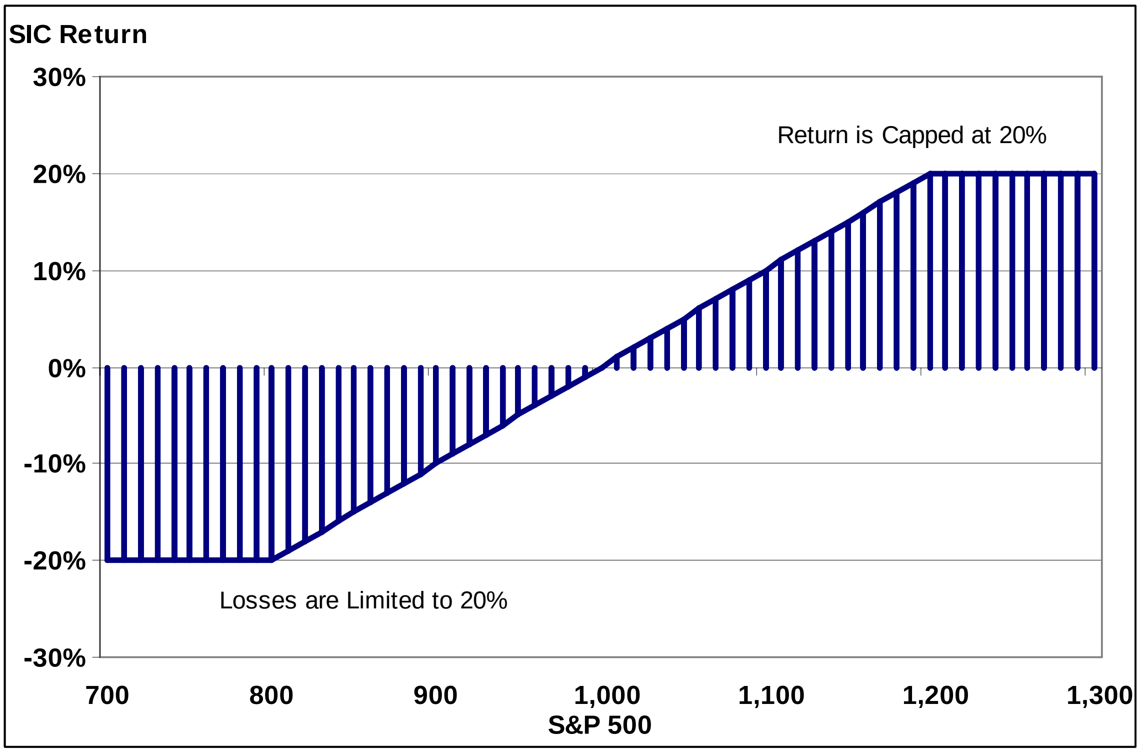
Chart 1: Example of a Collar



[2] A "put" option is a contract which gives the purchaser the right to sell an underlying asset at a predetermined price. If the purchaser exercises their put, the seller or writer of the option must then buy the underlying asset from the purchaser at the predetermined price regardless of the asset's market price.

Scenario A represents a situation in which the S&P 500 moves from 1,000 to 1,300. Without the use of derivatives, SIC would have purchased the underlying asset at 1,000 and subsequently achieved a positive return of 30 percent. However because SIC has sold a call[3] at 1,200, the counterparty would in this case exercise its option to purchase the asset at 1,200. Because options are a zero-sum game, SIC would then be forced to sell its S&P 500 holdings at 1,200 even though the market price is 1,300. This means that SIC will only realize gains on its holdings of 20 percent as opposed to the 30 percent it would have achieved without the call. Scenario B on the other hand represents a situation in which the S&P 500 moves from 1,000 to 700. Under normal circumstances, if SIC had purchased the index at 1,000, it would suffer a 30 percent loss. However, due to its put contract SIC would have the right to sell at 800 despite all other market participants having to sell at 700. SIC would reduce its loss to 20 percent, and thus beat the market by 10 percent.

Chart 2: Potential Return with Collar



Based on the simplified scenarios listed above, one could come to the reasonable conclusion that using <u>both</u> a put and a call option (a collar) is detrimental to overall returns and that SIC would be better served to use only a put option to mitigate downside risk. However, the scenarios above do not factor the prices of the put and call options into their calculations. As stated earlier, options are specialized agreements entered into between two counterparties. Someone must be willing to take up the opposite side of a transaction in order for SIC to enter into an options contract. These agreements are not made free of charge. If SIC were to purchase a put contract, they would have to pay a fee or premium determined by market conditions. Likewise if SIC were to write or sell an

[3] A "call" option is a contract which gives the purchaser the right to buy an underlying asset at a predetermined price. If the purchaser exercises their call, the seller or writer of the option must then sell the underlying asset to the purchaser at the predetermined price regardless of the asset's market price.

option, they would collect a fee from the counterparty entering into the contract with them. In a costless collar an investor can use these dual characteristics of options to offset each other, providing them with a "costless" hedge. If we take our example given above, a written call at 1,200 and a purchased put at 800, the strategy would only be costless if SIC were able to sell the call for the same price at which it purchased the put. Through the sale of the call SIC has sold some of its upside (i.e. limited its gains to 20 percent) in order to protect its downside (i.e. limited its losses to 20 percent).

Thus far SIC has been very successful at implementing hedging strategies. With one exception, both permanent funds have outperformed domestic equity benchmarks since the SIC implemented its hedging program in early FY08. The lone exception occurred in the second quarter of FY09 when SIC took the hedge off for fear of counterparty risk[4] in early September. These fears proved to be founded, as a short-time later Lehman Brothers declared bankruptcy and defaulted on thousands of derivatives contracts. Merrill Lynch, who served as counterparty to SIC at the time, nearly met a similar fate until they were acquired by Bank of America. Once SIC put the hedge back into place the market was rebounding and, due to the nature of a costless collar, neither permanent fund was able to fully capture the market rally and underperformed relative benchmarks. Although these types of strategies are intended to mitigate market risk, return variance, such as that seen in the second and third quarter of this year, raises the issue of market-timing. Due to continuously changing market conditions it is of course impossible to maintain the same costless collar position indefinitely. However, it would be untrue to say that this strategy, like most short term strategies, is immune from the inherent risks associated with market timing. SIC staff has thus far been very open and transparent with regards to this strategy, a trend which must continue in order to ensure the proper use of such a valuable investment tool. Without proper policies and procedures in place derivatives could be misused for speculation and increase the state's level of risk instead of mitigating it. Fortunately, SIC has a policy in place which states that the use of derivatives shall be "to protect the market value of the funds from losses attributable to declines in the market." The policy goes on further to explicitly state that "derivatives shall not be used to speculate."

[4] Counterparty risk is the risk that a contractual counterparty, usually an investment bank, will default on its obligation under the contract. This risk is especially prevalent in times of economic uncertainty.